



12-1-1973

Utility of the Close Corporation in Estate Planning and Administration

Donald H. Kelley

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

Recommended Citation

Donald H. Kelley, *Utility of the Close Corporation in Estate Planning and Administration*, 49 Notre Dame L. Rev. 334 (1973).
Available at: <http://scholarship.law.nd.edu/ndlr/vol49/iss2/5>

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

THE UTILITY OF THE CLOSE CORPORATION IN ESTATE PLANNING AND ADMINISTRATION*

Donald H. Kelley*

I. Introduction

A. Background

Since the basic juridical validity of the family corporation was recognized in the leading English decision of *Salomon v. Salomon & Co.*,¹ the family or "close" corporation has become increasingly significant as a business and property holding form. There has been a continued trend by statute and judicial decision to distinguish between the closely held corporation and the publicly held corporation.

The availability and the utility of the corporate form of doing business to the sole proprietor or family group has been further emphasized by the recent statutory trend to allow incorporation by one or more persons with a like number of directors,² the enactment of the Subchapter S provisions of the Internal Revenue Code,³ the adoption in some states of legislation specifically tailored to the close corporation,⁴ and the recent trend toward permitting the incorporation of professional persons and associations.⁵

As the Supreme Court of Illinois has recently stated in *Galler v. Galler*, "there has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*."⁶ The courts can no longer fail to distinguish expressly between the close and public issue corporation when confronted by problems relating to either.

As the basic principle that the closely held corporation shall be for all purposes treated as having a vitality of its own has come to have accepted commercial applications, so has a comparable principle entered into the development

* Mr. Donald H. Kelley is a partner in the law firm of Kelley and Wallace, North Platte, Nebraska.

1 [1896] A.C. 22 *rev'g* Broderip v. Salomon, [1895] Ch. 323. Salomon had incorporated his business, taking back certain secured debentures and all the corporate stock, except one share each to his wife and children. Arguments that the corporation was only a sham, or Salomon's alter ego, were rejected, and the fundamental principle was established by the House of Lords that *de jure* formation creates a distinct legal person regardless of the interdependence of the incorporators. See also MODEL BUS. CORP. ACT ANN. 2d § 36.

2 Scriggins and Rees, *Developments in State Corporation Law—1970*, 26 BUS. LAWYER 1751, 1767 (1971).

3 INT. REV. CODE OF 1954, § 1371 *et seq.*

4 MD. ANN. CODE, ART. 23, §§ 100 to 111; PA. STAT. ANN. tit. 15, § 1371. Legislation in other states containing provisions directed toward the special needs of close corporations is discussed in detail at 1 F. O'Neal, CLOSE CORPORATIONS § 1.14a (1971); e.g., the NORTH CAROLINA BUSINESS CORPORATION ACT permitting managerial acts by agreement of the shareholders without possibility of partnership liability. (Professor O'Neal's two-volume work encompasses in exhaustive fashion the background, unique aspects, and planning of the close corporation.)

5 The capitulation of the Service to the uniform attitude of the courts that state law governs the validity of professional corporations illustrates the vitality of the corporate form where the substance of the business is really that of a proprietorship or partnership.

6 32 Ill. 2d 16, 203 N.E.2d 577, 584 (1965).

of the Estate and Gift Tax Law. As the widespread use of corporate stock as a medium for transferring the beneficial ownership of the property underlying the stock has developed, so have approaches to the valuation of the stock as an entity distinct from the underlying assets. As a consequence, there has been increasing recent use of the close corporation as a deliberate estate planning vehicle under circumstances where business reasons alone might not be sufficient to motivate the incorporation.⁷

Recent decisions emphasizing the effect of the size of the stockholding in a close corporation upon the valuation of that stock and clarifying the degree of control which can be retained by a donor of such stock without the imposition of estate tax upon the donated stock further indicate the productive possibilities of using the corporate form specifically for estate tax planning purposes. Recent trends in this field have further pointed out the utility of the close corporation as a vehicle which can be expressly designed for the transmission of property from one generation to another. The unique attributes of the closely held corporation provide certain unique opportunities and unique problems in estate planning.

B. Judicial Recognition of the "Estate Corporation"

The recently decided case of *Britt v. United States*⁸ has firmly emphasized, restated, and refined the standards by which a corporation organized primarily for property or estate planning purposes will be upheld. The *Britt* case restates the judicial developments since *Moline Properties v. Comm.*⁹ and reverses a district court decision failing to recognize the validity of the corporations involved. In *Moline Properties* it was stated that the purpose of the incorporation is immaterial since, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."¹⁰

In the *Britt* case the taxpayers, who were partners in a citrus grove business, formed three corporations into which they distributed certain percentages of their partnership shares. Stock of the corporations was in turn given to two children of one of the partners and a sister of the partners. They maintained meticulous corporate and tax records; the corporation joined in the partnership notes; and dividends were paid from the partnership to the corporations. The corporations engaged in no other "business activity." The corporations were admittedly formed for the purpose of facilitating the transfer to the Britt children of interests in the partnership and had no other motivation. The argument was made that the corporation should be disregarded and the income taxed to the stockholders as if they were individually partners in the business. The Government argued that the corporations had "rather inconsequential activities"¹¹ and should be ignored for that reason. The court, in holding to the contrary, asserted that while business

⁷ See *Britt v. United States*, 431 F.2d 227 (5th Cir. 1970), *rev'g* *Britt v. United States*, 292 F. Supp. 6 (M.D. Fla. 1968).

⁸ *Id.*

⁹ 319 U.S. 436 (1943).

¹⁰ *Id.* at 439.

¹¹ 431 F.2d at 237.

activity is required for recognition of the corporation as a separate taxable entity, the activity may be minimal.

In 1960 the Second Circuit in *Commissioner v. State-Adams Corporation*¹² was presented with the question of recognition for income tax purposes of a corporation, the only asset of which was a long-term lease to a department store. The lease was assigned to the corporation in return for its promissory note payable to the prior lessor for life with the interest being equivalent to the amount of rent. The only activities of the corporation were the holding of the lease and the taking of steps necessary to continue its corporate existence. *Britt* summarized the holding in *State-Adams*, as follows:

The Court held that a corporation *formed to facilitate the devolution of property*, which merely holds title, collects rent from lessees and distributes the income has engaged in business and will be taxed as a separate entity.¹³

The *Britt* case characterized the previous cases where a corporate entity was disregarded as occurring when either "the taxpayer has conducted business as if he and the corporation were one and the same" or "artificial corporations have been created to contravene directly or indirectly the policies of the Internal Revenue Code."¹⁴ The corporation used as a concealment of or conduit to a transaction otherwise taxable in order to disguise its taxability may be disregarded under the principle established by *Gregory v. Helvering*.¹⁵ In that case the Supreme Court refused to recognize the existence of a corporation formed for the sole purpose of facilitating a corporate reorganization designed in form to conceal the real substance of the transaction and thereby contrived to avoid an otherwise appropriate income tax. This is an application of a more general concept enunciated in *United States v. Barwin Realty Co.*,¹⁶ that corporate form will not be permitted for the purpose of evading the law or interposed to defeat justice. The taxpayer, however, in transferring his property into the hands of other parties may legitimately choose the corporate form in which to do so. The *Britt* case and cases cited therein establish that a corporation formed for the sole purpose of facilitating the passage of property is not necessarily a device for the frustration of the Internal Revenue Code, and may serve as a legitimate vehicle for implementing a plan of tax avoidance where the criteria for treatment as a separate entity are otherwise adhered to.

II. Planning Advantages and Opportunities Provided by the Close Corporation

The essential objectives of any estate plan may be simply stated as the utilization of the legal devices provided by society for the holding of rights and property during one's life and the transmission of the same following one's death in order to pass such property rights to the desired persons in the desired proportions with the least reduction in the amount of such property through taxes and transmis-

12 283 F.2d 395 (2d Cir. 1960); *cert. denied*, 365 U.S. 844 (1961).

13 431 F.2d at 237 (emphasis supplied).

14 *Id.* at 233.

15 293 U.S. 465 (1935).

16 25 F.2d 1003 (E.D.N.Y. 1928).

sion expenses as is consistent with the other objectives sought. In certain situations a close corporation (or the close corporation together with the use of trusts holding the corporate stock) may serve as a uniquely efficient medium for accomplishing the succession of property upon death. The facets of the estate plan with respect to which the planner may find the corporate form useful are analyzed below.

A. Transmission of Property

Like the trust, the corporation may be used to create future interests in assets which do not otherwise lend themselves to the same (such as changing business inventory, depreciable tools and equipment, livestock or any other assets which are regularly replaced because of short life or business resale). Thus, a growing business may be held intact and transmitted through several generations with allowance for various family contingencies with the corporation. It is then a business operated in a business form, thus avoiding the inhibitions of trust management which might place a business at a competitive disadvantage even with a trustee who could be induced to accept the hazards of operating it. Self-renewing property, such as livestock, which is not susceptible to the creation of legal life estates, may still need to be transmitted through more than one person because of its continuity of life. Corporate stock representing the ownership of such property lends itself to the creation of life estates and remainders, powers of appointment, and forms of contingent ownership.

B. Estate Tax Avoidance

The persistent present inflation in property values continually increases the impact on the estate of both state and federal death taxes except where personal service forms the predominant earning power. Scarcely any business is capable of providing for a family with an investment of less than the \$120,000.00 of total specific exemptions available to both husband and wife under the Federal Estate Tax. As the United States Treasury becomes ever more significant in its role as an unwelcome forced heir, the number of estates reaching the size on which substantial efforts to disinherit the Treasury are worthwhile becomes increasingly larger. The businessman or landowner whose estate is beginning, through his own efforts and through the inflation of values, to face substantial death taxes may find incorporation of those holdings of particular use in achieving a minimization of death tax. Corporate stock may be of particular convenience in achieving the maximum marital deduction since life estates in the wife can be readily created in assets not otherwise lending themselves to use in maximizing the marital deduction (such as where the bulk of husband's assets are in a going business). The use of corporate stock to achieve the maximum marital deduction may allow both a convenient continuity for the family business and either facilitate the use of, or make possible the avoidance of the complexity of marital deduction formula distributions.

Further uses which have been made of the corporate form in death tax minimization are: (1) future growth or inflationary increase in value of assets

may be channeled to the shares given to donees through multiclass stock arrangements; (2) gifts of minority stock which reduce the gross estate of the donor, without substantial effect on the donor's ability to govern the operation of the corporate assets; and (3) it may now be possible for substantial blocks of gift stock to be placed in trusts of which the donor is either trustee or may otherwise control the voting power of the stock; the corporate form presents a unique capability, at this time, for the retention of control over the donor's assets by him while still divesting his estate of taxable value in the same.

C. *Estate Administration*

Incorporated assets are for all practical purposes administered through the corporation by the directors and officers elected by the stockholders. The executor of the estate of the deceased stockholder is still only a stockholder. He accounts to the probate court only for the value of the stock and dividends which he receives. It is necessary for him to go to the probate court for instruction only to the extent the voting of his stock involves difficult decisions warranting the request for instructions. No accounting to the probate court for the receipts and expenditures of the corporation relating to its business or other underlying assets need be made except to the extent necessary for the determination of tax liabilities. The operation of the assets or going business involved may thus be conducted with greater privacy than is the case with the proprietary asset holdings the extent and income of which must become matters of public record in the probate court. The officers of the corporation may conduct the business of the corporation and buy and sell its underlying assets without the necessity of requesting permission from the probate court for any particular action and without the extraordinary fiduciary responsibilities which they would face if operating as executor of such assets independent of the corporate form.¹⁷ As a result, estate administration may be greatly simplified and an otherwise unobtainable continuity of business operation may be achieved.¹⁸

The techniques and legal background relating to the implementation of the above possibilities are more fully discussed below.

D. *"Going Public" as Part of the Estate Plan*

A transmission of the family assets or family business from one generation to another for purposes of preservation of the same in kind, or as the transmission of a going business is primarily the subject matter to which this work is directed. Nevertheless, in certain situations it is necessary for estate liquidity or desirable for the objectives to be achieved by the testator and his family, that the testator's ownership in the family corporation be reduced to cash either in whole or in part. This need may be approached through variations of buy-sell agreements whereby stockholders who will be continuing to operate are obliged to purchase

¹⁷ This approach may be extended to another level by the testator through the medium of leaving property to a corporation directed by his will to be formed by his executor. Such a device may be used in lieu of a testamentary trust. Note, *Estate Planning for the Close Corporation*, 51 MINN. L. REV. 725 (1967).

¹⁸ See Younger, *Death and the Close Corporation*, 34 BROOKLYN LAW REVIEW 1 (1967).

the shares of heirs who will not be involved in the operation. This is familiar ground for estate planners. In those family businesses where suitable, an alternative approach is to attempt a private or public offering of stock in order to establish a market into which stock entering the testator's estate may be introduced.¹⁹

III. Estate Tax Avoidance Through the Estate Corporation

The holding by a decedent of stock in a family corporation and the gifts of such stock during his lifetime by the decedent result in various possible combinations of stock holding and have various effects on valuation of the stock for estate tax purposes. Factors affecting the valuation of close corporation stock and cases relating to it are discussed in detail below. To fully appreciate the opportunities involved, however, it is first necessary to examine the various classes of people giving and receiving such stock, the relevant percentages of stock ownership affecting valuation, and the various combinations thereof which arise.

The following outline, for simplicity, treats a family corporation having one class of voting common stock only. Similar factors would be equally applicable to corporations having more than one class of stock.

A. First Generation Estate

Stock reserved to the donor after the gift includes reservation to the donor of more than enough stock to control liquidation of the corporation (usually two-thirds). The tax effect of this is best illustrated by the *Estate of Gregg Maxcy*²⁰ case, in which, because of the problems related to corporate liquidation, stock of this category was discounted by the amount of fifteen percent below the value of the underlying assets. Incorporation may be particularly helpful where the assets involved have a low income yield in comparison with their comparative market values (at present this is the case generally with agricultural holdings). As to such property application of the factors of corporate stock, valuation may result in a lower value than valuation purely by comparative sales of comparable property would.

Reserved holding between fifty-one percent and two-thirds of the stock, reserving operating control, but not liquidating control also invokes the reasoning of the *Maxcy* case. The fact that this stock holding cannot compel liquidation will have a further decided effect on its valuation. In *Obermer v. U.S.*,²¹ a fifty percent stock holding of a corporation having underlying assets capable of ready liquidity was reduced by one-third below the asset value. The court laid great stress on the fact that the local law required two-thirds control of the stock to liquidate the corporation. The court made mention, also, of the expense

19 NATIONAL BANK OF COMMERCE ESTATE PLANNING STUDIES (Lincoln, Neb.: Autumn, 1970). Discussion of "going public" as a means of preparing an alternative for the liquidation of the testator's stockholdings is beyond the scope of this work; however, it has been the subject of a very interesting study by the trust department of the National Bank of Commerce of Lincoln, Nebraska, which is available upon request.

20 Estate of Gregg Maxcy, 69 P.-H. Tax Ct. Mem. 158 (1969).

21 238 F. Supp. 29 (D. Hawaii 1964).

and capital gain tax attendant to corporate liquidations, which factors would tend to reduce the value of stock holding at any degree of control. The *Obermer* reasoning would appear applicable to any holding not having liquidating control.

This exact situation has now come before the Tax Court. In the *Estate of Ethel C. Dooly*,^{21.1} one of the stockholdings valued was slightly more than 50% of the stock of a corporation owning ranch land and engaged in the ranching business. The underlying assets valued at approximately ten (\$10) dollars a share, but the Tax Court determined the value of this block of stock to be five dollars and twenty-five cents (\$5.25) per share. The factors applied by the Court are best stated in its summary of the testimony of the taxpayer's witness as follows:

The value ultimately selected by him was somewhat higher than the figures resulting from the earnings and dividend approaches and somewhat lower than that based upon asset value, and much of the reduction from asset value is properly accountable by the appropriate discounts for a minority interest and for liquidation.^{21.2}

The *Dooly* case is thus extremely significant as the first case clearly applying the relevant factors of earnings, capitalization, degree of control, and liquidating costs to arrive at a clear cleavage of value between stock controlling a corporation and the assets owned by the corporation.

Reservation of fifty percent of the stock in the donor is the exact situation treated of in the *Obermer* case. Reservation of less than fifty percent of the stock, whereby the donor is reduced to the position of a minority stockholder, is within the *Estate of Sidney L. Katz*²² and similar cases, including *Dooly*.

To the extent that the donated stock is not includible in the estate of the decedent under reservations made by the decedent, it is completely removed from taxability in the first generation estate upon the expiration of the three-year contemplation of death period. The donated stock given within the three-year period will still form a taxable part of the decedent's estate, but it will be taxed not as part of the decedent's original ownership, but as separate and distinct property. All the factors which would require the discounting of a minority ownership will apply to this type of stock. The cases appear to value donated property separately and at the value of the date of death of the donor.²³

B. Second Generation Estates

To the extent that stock in the hands of the donee and the heirs of the first generation individual continues to be minority stock it is subject to all the valuation reductions that may be appropriate to such stock. Stock in the hands of an individual person of the second generation is clearly at arm's length from the other stockholders unless unusual facts exist indicating a collusive situation. Its valuation may therefore be approached without the inhibitions involving the

21.1 31 T.C.M. 814 (1972).

21.2 *Id.*

22 *Estate of Sidney L. Katz*, 68 P.-H. Tax Ct. Mem. 171 (1968).

23 *McGehee v. Comm'r*, 260 F.2d 818 (5th Cir. 1958).

valuation of stock in the estate of the first generation owner where the possibility of collusive retention of control by the donor may be present. The valuation of the stock in the hands of the second generation people will be also much affected by the existence of restrictive agreements for repurchase by the corporation or other stockholders. The "Second Generation" situation is equally applicable to arm's length persons incorporating in the first instance in which each has a minority interest.

C. The Third Generation

The original planning must take into account what will happen to the stock in the hands of the third generation either by prescribing it or deliberately ignoring it. For example, the stock may be reconsolidated by restrictive repurchase or trust arrangement. Also, the stock may become fragmented as it passes down to various family lines.

The above outline illustrates also that to undertake the lessening of estate tax impact by gifts of minority stock creates other nontax planning situations which must be solved. It must be recognized in this context as in all others there is no medium of estate tax avoidance which is without its price.

IV. Valuation of Minority Stock

It is a common judicial statement that "minority stock interests in a 'closed' corporation are usually worth much less than the proportionate share of the assets to which they attach."²⁴ The Regulations recognize the valuation factor of the degree of control of the business, "either actual or effective,"²⁵ represented by the block of stock to be valued. Revenue Ruling 59-60, on the valuation of closely held corporation stock, states that "a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock. . ."²⁶ It is becoming continually better recognized by the courts that the latter fact is massively understated. The increasing impact of the "degree of control" factor and the parameters of valuation related to it are illustrated in *Maxcy* and *Katz*. In the *Maxcy* case there were involved the estates of two decedents, one of whom held 82 out of the 174 shares of the corporation. It was stipulated by the Service that this holding should be reduced by a twenty-five percent discount below the attributable underlying asset value. In the *Katz* case the decedent held shares amounting to approximately one-fifth of the corporate shares. The court held that this holding should be discounted by fifty percent to reflect lack of marketability resulting from the corporation's not having publicly marketed stock. "Discount" of minority stock below the attributable value of the underlying assets within the range indicated by these two cases is now sufficiently common to require its recognition in estate planning as well as in gross estate valuation. It is commonly reasoned in the cases on this point that valuation of minority

²⁴ *Cravens v. Welch*, 10 F. Supp. 94, 95 (S.D. Cal. 1935).

²⁵ TREAS. REG. § 20.2031-2(e) (1972).

²⁶ Rev. Rul. 59-60 § 4.01(g), 1959-1 CUM. BULL. 242.

share holdings must be reduced to reflect the lack of control over dividend payment and the lack of control over corporate liquidation.²⁷

A. *Valuation Regulations*

The basic theory of the Federal Estate Tax should not be lost sight of in valuing stock of a closely held corporation. In the valuation of assets of a decedent subject to the tax, the Internal Revenue Code provides that a tax is imposed on the transfer of the taxable estate of every decedent.²⁸ "Taxable" is defined as the gross estate less the exemptions and deductions allowed by law, while the gross estate is defined as the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.²⁹

The tax is imposed as a true "estate tax," not upon what the heirs receive, but upon the assets as they were in the hands of the decedent. It is elementary, therefore, that other stock in the hands of the heir could not be taken into account in valuing what he receives, and other stock previously given by the donor cannot be taken into account in valuing what he has retained. It is only the fair market value of the block of stock held by the decedent as such block could be marketed at the date of his death, which forms part of the gross estate.

The regulations relating to the valuation of stocks and bonds state that the fair market value is to be determined by taking into consideration in the case of shares of stock, the company's net worth, prospective earning power and dividend paying capacity, and other relevant factors.³⁰ Some of the other relevant factors referred to are the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry and its management, and the degree of control of the business represented by the block of stock to be valued.³¹

B. *Revenue Ruling 59-60*

In implementation of Section 2031 and the Regulations adopted under it, Revenue Ruling 59-60³² was issued. This ruling sets forth in elaborate detail the accepted and recognized appraisal practices for the valuation of stock in a closely held corporation where there is no market in the stock from which to draw direct evidence of market value. If there is one principle abundantly clear from the ruling, it is that valuation of such stock must be a blend of all the relevant factors bearing upon the ultimate reality of what would happen to the actual shares of stock to be valued in the market place as of the date of valuation. No one factor is to be predominant; net worth is only one relevant factor in reaching the ultimate determination of value. In this regard, the following features of this ruling are particularly notable:

27 *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

28 INT. REV. CODE OF 1954, § 2001.

29 INT. REV. CODE OF 1954, §§ 2051, 2031(a).

30 TREAS. REG. §§ 20.2031, 20.2032.

31 *Id.*

32 Rev. Rul. 59-60, 1959-1 CUM. BULL. 242.

(Section 2) .01 [T]he property to be included in the gross estate, . . . shall be taxed on the basis of the property at the time of death of the decedent,

.02 [T]he Estate Tax Regulations . . . define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.

(Section 3) .01 No formula can be devised which will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. A sound valuation will be based upon all the relevant facts.

(Section 4) .01 [I]n the valuation of the stock of closely held corporations . . . [t]he following factors, although not all-inclusive are fundamental and require careful analysis in each case:

- (a) The nature of the business and history of the enterprise from its inception;
- (b) The economic outlook . . . of the specific industry. . . .
- (c) The book value of the stock and the financial condition of the business.
- (d) The earning capacity of the company
- . . .
- (g) Sales of the stock and the size of the block of stock to be valued.³³

The ruling also sets forth the items of evidence which establish the applicability and weight of each of the above factors, including the following: 1. "[A] study of the growth and net income of the business, . . . the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records, and management," 2. "[C]urrent and prospective economic conditions as of the date of the appraisal," 3. "[T]he effect of the loss of the manager on the future expectancy of the business," 4. "[A]nnual statements for two or more years immediately preceding the appraisal," which balance sheets will disclose evidence of liquid position, gross and net book value, working capital, long-term indebtedness, capital structure, and net worth, 5. "Detailed profit and loss statements should be obtained and considered for a representative period. . . ," and 6. "The size of the block of stock itself is a relevant factor to be considered."³⁴

The Revenue Ruling clearly recognizes that *a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock*. This factor is characterized in some cases as a lack of "marketability."³⁵

C. Net Worth

The net worth of a closely held corporation is one (but only one) of the factors contemplated by the relevant regulations, rulings, and cases relating to the valuation of shares of stock in a closely held corporation. The mere fact of incorporation, regardless of the division of stock ownership, makes the multiple valuation factors of Revenue Ruling 59-60 applicable. Properly weighing the

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

various factors indicated by Revenue Ruling 59-60 can result in a substantially different measure of value for the stock after incorporation than would be typically applied by the Revenue Service in the course of estate tax audit to the assets without incorporation. For example, land is uniformly approached by the Internal Revenue Service in the course of audit on the basis of comparative sales only without any adjustment for low earning capacity if such be the case. At the present time agricultural land, in general, appears to have values inflated in the market place beyond anything which the earning capacity of the land will justify. Since there are no regulations bearing specifically upon the value of real estate, it is difficult to counter the argument that it should be valued solely for what it will sell for. If the same real estate is incorporated, there at least become available the elaborate regulations and rulings relating to the valuation of corporate stock from which to argue that more weight should be given to the income capitalization factor that is normally the case in land valuation by the Internal Revenue Service.

Further, if the stock to be valued represents less than an interest which can compel liquidation (typically, a two-thirds ownership of issued and outstanding stock) or represents an interest less than that which can control operation of the corporation (fifty-one percent would be required to dominate the Board of Directors) many factors other than the net worth of the corporation enter very realistically into the valuation of the shares. The relevance of the net worth of the corporation to the value of stock not having liquidating control has been delineated as follows:

The liquidating value, however, is not a sound measure for valuing shares in a going concern, especially minority shares. [Citation omitted.] In *Mathilda B. Hooper* [41 B.T.A. 114], we said: "A prospective buyer would give some consideration to the book value of a \$145.00 share. He would realize, however, that the company was a going concern and that even if it be assumed the book value could be realized upon liquidation of the corporation, there was no indication that it was to be liquidated. Moreover, he would also realize that 'minority stock interests in a "closed" corporation are usually worth much less than the proportionate share of the assets to which they attach.'"³⁶

In the case just quoted the court valued the stock at almost fifty percent less than book value.

The above analysis is substantially that adopted by the Tax Court in the *Estate of Ethel C. Dooly*.^{36.1} This opinion deserves particularly close study by a practitioner contemplating estate tax planning through the close corporation form or otherwise valuing close corporation stock. As therein stated by the Tax Court:

The respondent (Internal Revenue Service), in essence, contends that the stock valuation should be based solely on the value of the assets of Island

³⁶ *Estate of Charles W. Heppenstall*, 49 P.-H. T.C. Memo 115, 121 (1949) (emphasis supplied).

^{36.1} 31 T.C.M. 814 (1972).

Ranching***under similar circumstances this court has refused to uphold the respondent's determination that the value of stock of an operating corporation should be determined solely on the basis of asset value.^{36.2}

The taxpayer in the *Dooly* case submitted the testimony of appraisers valuing the assets utilized in the ranching business of the corporation with the greatest weight being given to comparative sales. Taxpayer then offered a further witness experienced in the marketing of corporate shares who approached valuation of the stock in question first through capitalizing the corporate income at a typical rate of return required by investors in business, and weighting the same with the asset value; and then arriving at the value of the stock blocks by further weighting the factors of degree of control and problems related to liquidation. The Tax Court expressly countenanced addition of the earnings factor, where the corporate stock is involved as opposed to physical property valuation only, stating: "Thus in ascertaining the fair market value of the stock of Island Ranching, both earnings and asset value should be considered."^{36.3}

D. Earning Power

Since a corporation is valued as a going entity for the purpose of reaching the valuation of shares, the earning power and the dividend paying capacity of the corporation are necessarily involved. Earning power is approached by the cases after the manner of the income capitalization approach of appraisal to real estate valuation. The two factors involved in income capitalization valuation are: the income of the business or real estate entity involved and the rate of capitalization to be used in determining the underlying value which that income justifies. Revenue Ruling 59-60 outlines the factors to be taken into account in determining a capitalization rate. The Ruling states in part:

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. Among the more important factors to take into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.³⁷

Revenue Ruling 68-609 further expands the techniques of applying the income capitalization method as a factor of valuation (particularly where this approach would produce an intangible value in excess of the market value of the tangible assets involved).³⁸ This ruling suggests the use of a base period of not less than five years immediately prior to the valuation date and application of the capitalization rate to the average earnings for the base period. It further suggests determination of separate capitalization rates for establishing earnings from intangible assets and tangible assets. This ruling suggests a rate of return

36.2 *Id.*

36.3 *Id.*

37 Rev. Rul. 59-60 § 6, 1959-1 CUM. BULL. 243.

38 Rev. Rul. 68-609, 1968-2 CUM. BULL. 327.

on tangible assets of eight to ten percent when an accepted industry-wide percentage is not available and suggests a rate of return on intangible assets of fifteen to twenty percent. The rate used would depend upon the hazards and risks of the business and the stability of earnings.

In the *Dooly* case, the Internal Revenue Service attempted to blunt the effect of interjection of the earning power factor by arguing that the capitalization rate should reflect only the average rate of return in the agricultural industry. The taxpayer's witness had used a seven percent capitalization rate. The Service submitted testimony that the average rate of return on a ranching operation in Utah where the ranch in question was located is around two percent. The Tax Court disposed of this argument as follows:

The respondent, therefore, suggests that a 2% capitalization rate should be used. *Yet, the capitalization rate and the average rate of return on capital are not the same.* The capitalization rate is the rate of return in which an investor is willing to invest his funds, taking into consideration the risk factor involved and the investment being contemplated. Dewing, Financial Policy of Corporations 288 (5th edition 1953). Thus, in determining the capitalization rate, an investor would take into account the rate of "riskless" investment and add in an allowance for the risk involved and the particular investment being contemplated***because the petitioner's appraisers used a capitalization rate which is within the realm of reason, and because there was no evidence indicating that a lower rate should be used, we uphold the petitioner's use of the 7% rate.^{38,1}

The Tax Court thus establishes that the valuation of close corporate stock is to be approached as an intangible related to the requirements of the investing community, rather than as a tangible asset related to the income acceptable to operators in the industry involved. In other words, land, or other assets, may be purchased at a value reflective of psychological considerations, but the purchaser of stock must take into account as a factor the limitations which that stock places between him and the asset involved.

E. Degree of Control

The degree of control was the substantial factor in the case of *Whittemore v. Fitzpatrick*.³⁹ In valuing blocks of 200 shares out of 820 shares, the court reached a valuation of thirty-four percent of the proportionate value of the underlying corporate assets based substantially upon the factors that a minority shareholder cannot control dividend payment and cannot control corporate liquidation. There are many cases bearing upon the effect of control on valuation of stock and the statement is regularly quoted that "minority interests in a closed corporation are usually worth much less than the proportionate share of the assets to which they attach."⁴⁰

The factor of control was applied to even fifty percent ownership in *Ober-*

38.1 31 T.C.M. 814 (1972).

39 127 F. Supp. 710 (D. Conn. 1954).

40 *Cravens v. Welch*, 127 F. Supp. 710 (D. Conn. 1954).

mer v. United States.⁴¹ In that case the block of stock to be valued consisted of 100 shares of an investment company which had 200 shares issued and outstanding. The corporation involved was a personal holding company necessarily compelled to distribute all its annual earnings. The assets of the company consisted of liquid bonds and certificates of deposit of \$189,000 and common stocks of \$1,228,000, against which there were outstanding debentures of the company totaling \$350,575, with accrued interest. The underlying nature of the situation was, therefore, that of readily marketable assets having a more or less regular income not subject to the risks and hazards of assets consisting of either real estate or an operating business. The court mentioned problems relating to the retirement of the debentures and the capital gains tax upon stock sale necessary to retire the debentures. The predominant factor, however, in valuation was stated to be that of control, and the court made reference to the local law requiring two-thirds control of the stock to liquidate the corporation. The court held the block of stock involved should be valued at two-thirds of the adjusted book value (net worth) of the corporation.

The *Maxcy* and *Katz* cases discussed above illustrate recent positions of the tax court on the application of the degree of control factor. In the *Katz* case this factor was also verbalized as having relation to the "marketability" of the minority stock interest there involved. If there is a ready market for the shares of stock being valued, the prices established in that market govern. The discussion of this section is related to those situations where there is no ready market for the stock, particularly where the stock is held only in the hands of a single family. Minority quantities of stock are, from the strict viewpoint of the marketplace, worthless. Typically in family corporations there is little, if any, dividend distribution, profits are distributed primarily through salaries, and management is thoroughly centralized in the hands of one or a few people. A stockholder having less than one-third of the stock of such a corporation has no bargaining power whatever except for the amount of nuisance he is willing to make of himself in terms of lawsuits alleging abuse of his position as a minority stockholder. If the corporation has a low income to assets ratio and any sort of realistic need for accumulation of this income, his position would be unlikely to bear any fruit in the course of litigation. In this light, the heavy discount from valuation of underlying assets made in the *Katz* case is not only realistic but may well result in a value that is somewhat optimistic.

On this point, the testimony of the valuation expert testifying for the Internal Revenue Service in *Righter v. United States*⁴² is particularly significant. The witness testified that since the stock in question was not publicly traded, it "lacked marketability."⁴³ He stressed that "the three hundred thirty-seven share block being evaluated represented only a minority interest"⁴⁴ (the block involved was seventeen percent of the stock of the corporation). The witness also stressed that the corporation was in a highly competitive business with some risk. The witness felt that a discount of approximately forty-five to fifty percent in the hypothetical

41 238 F. Supp. 29 (D. Hawaii 1964).

42 439 F.2d 1204 (Ct. Cl. 1971).

43 *Id.* at 1213.

44 *Id.* at 1214.

selling price of the stock was warranted by reason of these factors.

The *Righter* case also illustrates another aspect of minority stock valuation in that the price from which the expert worked in determining the minority stock discount was determined by the application of the general ratio of stock price to book value prevalent in the industry to the book value of the particular corporation being appraised. Such industry-wide averages, if available and if properly comparative, may be of assistance in determining the aspects of intangible valuation of a corporation.

The Court of Claims has again given substantial weight to the degree of control factor in the recent case *Smith v. United States*.⁴⁵ In this case the corporation engaged in a home remodeling business that had losses for four of the previous five years, but the value of the corporation's real estate had been increasing. The net worth of the corporation averaged about \$144.00 a share; the deceased owned 41.4 percent of the issued and outstanding stock of the corporation. The Revenue Service admitted that the decedent's shares were worth about twenty percent less than the net worth per share, or \$118.00 a share. The state took the position that the decedent's holdings were worth no more than \$75.00 per share. The court held the correct value to be \$84.10, thereby allowing approximately a forty percent reduction from net worth. The court reasoned that in the absence of any actively traded comparable companies, no objective comparison of market value as related to earnings, dividends, and book value was possible. Primary weight was given to the fact that the equity interest was a minority interest. The court noted that a "prospective investor would be unable to force the payment of a dividend or the liquidation of the company."⁴⁶

The degree of control considerations discussed above culminate in the *Dooly* case, which involves blocks of both slightly over 50% and under 10% of the outstanding stock of the corporation involved. The Tax Court in approving the values placed on the stock by the taxpayer's witness (as that testimony is discussed above) stated:

Both blocks of stock were valued with the understanding that neither block represented power sufficient to liquidate the corporation, and the difference between the value of the majority and the minority block is due to the fact that the holder of the majority block could control the operation of the business while the holder of the minority block could not do so.^{46.1}

F. Restrictive Transfer Provisions and Purchase Agreements

Regulation 20.2031-2(h) recognizes that amounts of payment fixed by agreements for the purchase of stock in a closely held corporation govern its value for Federal Estate Tax purposes provided that the terms of the agreement to purchase are binding during the lifetime as well as at the death of the shareholder, and that the agreement must represent "a bona fide business arrange-

⁴⁵ Ct. Cl., Com. Rept. No. 430-69 (Nov. 11, 1971).

⁴⁶ *Id.*

^{46.1} 31 T.C.M. 814 (1972).

ment and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth."⁴⁷ The applicable ruling is Revenue Ruling 54-76,⁴⁸ which states that when shares in the issuing corporation were acquired by decedent subject to an option reserved by the issuing corporation to repurchase the stock at a price therein determined, this price is to be treated as the value of the stock for Federal Estate Tax purposes. Revenue Ruling 59-60 also recognized that where "shares of stock were acquired by the decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes."⁴⁹ Ruling 59-60 as the general statement relating to the valuation of shares in closely held corporations directs that such agreements be considered as one of the factors in valuing such stock.

In the *Estate of Albert L. Salt*⁵⁰ the decedent stockholder was required by a restrictive agreement entered into with the other stockholders of the corporation to offer the stock for sale to the corporation at the issuing price before transferring it to third parties. The agreement applied both during his lifetime and to his estate at his death. The tax court held that the value established by this agreement fixed the valuation of the decedent's shares for Federal Estate Tax purposes. The same principle was applied in the *Estate of Orville B. Littick*.⁵¹ This case is of particular interest when considered in the context of the use of the corporate form and corporate stock controls for family business and estate planning purposes. All shares in the corporation were owned by the members of a single family who had entered into an agreement providing that the corporation would buy the shares of any deceased shareholder at a price determined by the terms of the agreement. The court found that this agreement was entered into to ensure continuity of ownership of the corporation in the family and stated:

Where, for the purpose of keeping control of a business in its present management, the owners set up in an arm's-length agreement, . . . the price at which the interest of a part owner is to be disposed of by his estate to the other owners, that price controls for estate tax purposes, regardless of the market value of the interest to be disposed of.⁵²

Any such agreement inhibiting the ability of the taxpayer to reduce his shares to cash will tend to reduce the valuation of the shares. A third party would, of course, be unwilling to offer any amount for shares in excess of the price at which someone has an option to purchase them whether it be the corporation or other shareholders. If the agreement or option takes the form of requiring a first tender to either a corporation or other stockholders capable of buying the stock, it operates as an effective restriction against transfer or sale to any third party; and the amount of the option would have the effect of fixing the

47 TREAS. REG. § 20.2031-2 (1972).

48 Rev. Rul. 54-76, 1954-2 CUM. BULL. 194.

49 Rev. Rul. 59-60 § 7, 1959-1 CUM. BULL. 243.

50 17 T.C. 92 (1951).

51 31 T.C. 181 (1958).

52 *Id.* at 187.

maximum worth of the stock to the holder of it. If the value fixed by the agreement should be very low in relationship to a stock with a high dividend paying history and the option is exercisable only upon the possibility of transfer to third parties, a proper fair market value might be in excess of the option figure.

In this last regard, careful attention should be paid to the *Estate of Pearl Gibbons Reynolds*.⁵³ In that case the decedent and the family of the decedent owned virtually all the units in a voting trust. The voting trust held the majority of the shares of a life insurance company. Under the terms of a voting trust, its units could not be sold unless first offered to other holders of units at a price based upon a formula applied to the company dividends. If refused by the other unit holders, the units would have to be offered then to the Board of Directors of the life insurance company at the same formula price. The units could be transferred, but remained subject to the restriction. The formula price would result in a value per unit less than the proportionate share of that unit to the over the counter selling price of the life insurance company's stock forming the subject matter of the trust. The Tax Court ruled that in determining the units' fair market value for estate tax purposes, the first offer restrictions were only "relevant factors"⁵⁴ to be considered with all other valuation factors, and that neither the price of the underlying shares nor the formula price represented an absolute index of the fair market value. It is difficult to reconcile the *Reynolds* case with previous tax court cases, and it does inject an element of some uncertainty into the situation.

Stock purchase agreements may arise in the following circumstances:

- (1) As an arm's length agreement among several stockholders having each contributed capital or each purchased stock for value;
- (2) As a restriction imposed by a donor or testator upon stock given to several persons providing for purchase option among themselves;
- (3) As an option or restriction reserved to a donor or a corporation in which the donor retains control, imposed upon gifts of stock to others; or
- (4) As purchase options or various restrictive purchase covenants given by a donor to other persons whether accompanied by gifts of stock or otherwise.

The first instance is clearly a "bona fide business arrangement" within the meaning of the Regulations. The second and third instances are not business arrangements but nevertheless represent realistic handicaps on the marketability of the stock in question. In restricting the ability of the donee or legatee to market his stock, they should, consequently, be recognized as affecting the valuation in his estate.

The fourth instance is apparently the situation attempted to be caught for estate tax under the Regulations above quoted. A gift of a bona fide legally enforceable option to purchase the donor's stock does, however, effectively reduce

⁵³ 55 T.C. 172 (1970).

⁵⁴ *Id.* at 200.

or govern the fair market value of that stock in the hands of the donor or his estate. The proper analysis, therefore, is that a taxable gift takes place to the extent that the fair market value of the donor's stock before the gift exceeds the option figure. The stock in the donor's estate should be valued in response to the outstanding option. If the option is exercisable only at the decedent's death, it would be the equivalent of a transfer with possession and enjoyment retained and should not affect the valuation of the property in the decedent's estate. If it is exercisable during his lifetime, it is difficult to see that there has been anything but an absolute gift of the increment of value above the option price.

Such stock agreements may take various forms whether they form part of the organic structure of the corporation or are a separate contractual or stock transfer arrangement among the stockholders, including:

- (1) An ability to match the bona fide offer of a third person,
- (2) An option to purchase the shares at an agreed price, or price determined by an agreed formula, within a period of time after notice by the shareholder that he intends to sell or mortgage his shares if the option is not exercised,
- (3) An option to purchase at an agreed value, or value arrived at by an agreed formula, upon the death of any shareholder,
- (4) An absolute agreement to purchase at such price upon the death of a shareholder.

Such agreements perform the function of enabling centralized retention of the stock to take place. They achieve the results of keeping out nonfamily members and preventing fragmentation of the stock into numerous hands as the stockholders pass away.

Extreme care must be taken in fixing the formula for the purchase. If it is held below market value to deliberately reduce estate tax values or for other reasons, the result is to create a windfall to the stockholders living the longest. Thus, an overzealous desire to reduce estate taxes or pass inflationary values to the surviving stockholders may result in substantial unfairness to the estates of the earliest decedents. At least, if such a Tontine-like effect is desired it should be entered into deliberately and not inadvertently. It may be that the corporation or the survivors cannot be expected to be able to afford to pay the full market value of the stock of a corporation having low earning power in proportion to asset value. It thus may be realistic and necessary to relate the purchase formula to the corporation's earning power rather than its liquidation potential if a realistic ability to reconsolidate stock ownership is desired. Care should be taken to assure that such purchase options are consistent with the Regulations under Section 2031. Conceivably an option which was not effective during the lifetime of the decedent but applied at his death could leave his shares valued at their full market value, but cause his estate to be either handicapped in paying the estate tax or facing a difficult apportionment problem. Testamentary options to purchase are common, and proration of estate tax between the person having the option and the persons receiving the cash payment ultimately can be made.

G. Summary

In summarizing the rules of law applicable to the valuation of close corporation stock, no better statement can be made than the following quotation from *Righter v. United States*:

We held in *Penn Yan Agway Cooperative, Inc. v. United States*, 189 Ct. Cl. 434, 417 F.2d 1372 (1969):

It is a well established rule of law, carefully analyzed and stated in *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962), that *the market value of common stock* in a closely held corporation, there being no market sales of such stock, *must be determined upon consideration of all relevant factors*, such as earning capacity, anticipated profits, book value, and dividend yield. [Emphasis supplied] [Citation omitted].

We find a similar statement in *Arc Realty Co. v. C.I.R.*, 295 F.2d 98 (8th Cir. 1961) as follows:

The question of "fair market value," defined to be "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed," *O'Malley v. Ames*, 8 Cir., 197 F.2d 256, at page 257; *Fitts' Estate v. Commissioner of Internal Revenue*, 8 Cir., 237 F.2d 729, 731, is one of fact and cannot be established on the basis of fixed rules or formulae. Among the factors properly to be considered in making the determination are corporate assets, earnings, dividend policy, earning power of the corporation, prospects of the corporation, book value, character of the management, competition and other factors which an informed purchaser and informed seller would take into account.⁵⁵

V. Application of Minority Stock Techniques to the Reduction of Estate Tax Values

The Service seems to be working toward the general position that the aggregate value of all outstanding shares of a close corporation will be no less than the value of the underlying assets. In economic reality the advent of the corporate form can create a less marketable situation than would exist without it (for example, the *Maxcy* case).

Unrelated arm's length minority stockholdings in a close corporation must each individually be subject to discount in the hands of the respective owners thereof since a purchaser is afforded the opportunity of being able to deal with one owner at a time on the basis of the limited market available for that owner's minority stock. From the estate tax point of view solely, it is possible that one of the effects of incorporation can be a significant reduction in the fair market value of the total gross estate of any given owner through the substitution of minority stock for the ownership of certain defined assets. Some of the various approaches toward this result are as follows:

⁵⁵ 439 F.2d 1204, 1217-18 (Ct. Cl. 1971) (Court's emphasis).

A. Incorporation of business or investment assets by the owner thereof and gifts of stock to others: The effect of this is to reduce the aggregate value to the sum of values of stock in the owners' hands. The amount of reduction depends on the degree of control remaining in the hands of the owner-donor.

B. Restrictive Agreements: The addition of a covenant restricting the right of the corporate stockholders to sell their stock freely and openly to third parties necessarily results in a reduction of the value of that stock. It has been regularly held by the courts that a restriction which provides a specific formula for buy-back of stock by the corporation or other stockholders during the life of the stockholders and which is binding upon death fixes the value of the stock. Any form of restrictive covenant will probably have a downward effect on the stock value. The restrictions which may be imposed may take many forms including the option of the corporation or the stockholders to match a bona fide offer; to purchase the individual stockholder's stock if he offers it for sale, at a formula price; and to purchase the individual stockholder's stock in the event of his death, at a formula price. At the extreme, such formulas may fix very low or unrealistic values on the stock (such as a formula relating the buy-out to the contribution value of the stockholder's assets when there has been a substantial inflation of that value). The result may be a Tontine-like effect whereby the survivor of the initial stockholders or of the "second generation" stockholders may have a considerable windfall. The repurchase agreement may extend to either the corporation or the stockholders or to the stockholders alone in the event the corporation does not have sufficient liquid assets to exercise the option.

C. The Creation of Multiclass Stock by the Owner-Donor: In this approach a class of preferred stock is issued to the extent of the value of the assets contributed to the corporation. A small class of voting common is retained by the donor and a larger class of nonvoting common is given to the donees. One of the uses of this approach is to retain in the ownership of the donor the value of the assets at their contribution and to retain complete control in his hands, but to make gifts of the entire growth or inflationary value of the underlying assets. The use of multiclass stock provides an alternative to restrictive agreements in controlling the stock voting power.

D. Stock Classification: This uses separate classes of voting common and nonvoting common without the issuance of preferred stock. By this means the donor can retain complete control of the corporation but give away the right to most of the dividends, if any, and preferred participation in liquidation in the form of the nonvoting common stock. It would appear from *Byrum v. United States*⁵⁶ and *Yeazel v. Coyle*⁵⁷ that such an approach will not cause the donated stock to be taxed in the estate of the donor, nor perhaps will the gift of shares of voting common with an agreement back that the donor shall vote all the stock cause it to be taxed to the donor.

E. Trust: The donated stock may further be placed in a trust for the objects of the donor's bounty. This would allow flexibility responsive to future events. In the event of the death of one of the beneficiaries, the value involved is cor-

⁵⁶ 408 U.S. 125 (1973); *reh. den.* 409 U.S. 898 (1973), *aff'd*, 408 U.S. 125 (1972).

⁵⁷ 68-1 U.S.T.C. ¶ 12,524 (N.D. Ill. 1968).

respondingly reduced in the light of whatever obstacles the intervention of the trust puts between the donee and the stock. (Some gift tax problems can arise in this regard as discussed below.) The *Byrum* and *Yeazel* cases utilize the device of placing voting stock in a trust so arranged that the donor could control the voting of the stock, but would not receive any income or principal distributions. From the estate planning viewpoint, such an approach allows the donor to divest of all ownership in the stock, separate income from principal, if desired, and create future interests in and contingent successions to the corporate stock but still retain operating control of the business during his lifetime. The estate tax consequences of this method are discussed more fully below.

F. Charitable Remainders: Since the gift of stock lends itself conveniently to trust treatment or to legal life estates and remainders, charitable remainders after the life of the immediate beneficiaries can be further used to reduce the estate tax of the donor's estate.

G. Income Tax Effects: The utility of the trust approach is lessened, however, for the reason that the Subchapter S selection is not available to a corporation having a trustee as a shareholder. It may be held that this unfair and discriminatory rule may be alleviated by future legislation. The ABA-treasury committee on Subchapter S corporations has recommended that the present limitation of ten shareholders for a Subchapter S option be increased to fifteen, particularly if the increase is by inheritance. This would help alleviate one of the problems in the utilization of corporate stock for transmission of property where Subchapter S status is desired and the descent of the stock might terminate the election by increasing the number of shareholders beyond the statutory limit. The ABA-treasury committee proposals also include provisions that trusts created by the donor's stock may be a stockholder without termination of the election and that the holding of stock in voting trust does not terminate the election. The proposals contained similar provisions curtailing termination of the election inadvertently by the holding of stock on a transitory basis by an ineligible stockholder, such as a trust. The ABA-treasury proposals further suggest modification of the rule allowing one class of stockholding only to allow the Subchapter S option to be available to corporations having classes of nonvoting stock. Congressional adoption of the above proposals would greatly expand the estate planning utility of the corporate form.

VI. Permissible Retention of Control of Gifted Stock

Recent Revenue rulings and cases have sharply focused on the degree to which voting control or other benefits can be retained from stock otherwise given away by the donor without rendering the same liable in the estate of the donor for estate tax. Use of corporate stock as a medium for the succession to the donor-testator's assets offers some unique opportunities for the donor to have his cake and eat it too. Various approaches to the transfer of asset values to others while retaining some degree of control over the management of the assets involved have, in certain instances, been approved by the courts even though heavily attacked by the Internal Revenue Service. The cases approving such transfers and the areas of attack upon them by the Internal Revenue Service of late are discussed below.

Transfers of majority stock have been attacked under various circumstances as being transfers with "possession or enjoyment" of or "right to income from" retained in the person holding majority control of the corporation—under I.R.C. 2036 (including retention of right to designate persons who shall possess or enjoy the property in or income from the donated stock).

Reservation in the donor of the right to the dividends from the stock will render the stock taxable to the donor as being the substantial equivalent of a life estate under 2036.⁵⁸ Similarly, an initial endorsement of dividends back to the transferor by the donee results in such taxability.⁵⁹ Reservation of an agreed salary so large as to amount to a reservation of the dividends from the stock given will cause the stock to be taxed to the donor's estate as above.⁶⁰ Reservation of a reasonable salary at a fixed level, even though it is to be paid regardless of physical condition or inability to serve, does not of itself cause inclusion in the transferor's estate.⁶¹ The application of Section 2036 requires a finding of an understanding at the time of the gift for the retention of possession, enjoyment, or income in order to render the gift taxable in the estate of the donor.⁶² The recent cases seem to indicate a reluctance by the courts to imply such retained rights in absence of proven express agreements.⁶³ Earlier cases implied such agreements from the circumstances surrounding the gift, and the regulations under 2036 provide that an "interest or right is treated as having been retained or reserved, if at the time of the transfer there was an understanding express or *implied*, that the interest or right would be later conferred."⁶⁴ The question remains as to how far this approach can be carried into the fact situation where the retention of control in the hands of the donor gives him complete ability to control dividends, and corporate history since the gift reflects a salary or interest payment substantially absorbing the corporate net income. Transfer by gift of interests having substantial restrictions imposed by arm's length agreements between the donor and others or imposed upon the donor from previous gratuitous transfers should not, of course, render such gifts subject to estate tax in the estate of the donor. Such gifts are completed when made to the extent of the quantity of the donor's interest regardless of third party restrictions imposed.⁶⁵

The right to utilize the donated stock as collateral amounts to an ability to apply its value to the donor's purposes and deprive the donee of the property in

58 *Riley, Admrix, v. Meyers*, 59-1 U.S.T.C. ¶ 11, 874 (D.C.N.Y. 1959).

59 *Atkinson v. United States*, 231 F. Supp. 933 (E.D.S.C. 1964).

60 *Estate of Pamela D. Holland*, 47 B.T.A. 807 (1942), *modified*, *Estate of Pamela D. Holland*, 1 T.C. 564 (1943). A similar result was reached in the *Estate of James Gilbert*, 14 T.C. 349 (1950), in which case stock conveyed by a sole stockholder to his wife was held includible in his gross estate where agreements incidental to the transfer gave the corporation the right to pledge the stock for corporate loans, gave the stock a thirty-day option to repurchase the shares in the event of any bona fide offer by a third party for the same, and required the wife to will any stock owned by her at death to the corporation.

61 *Estate of William L. Belknap*, 51 P.-H. Tax Ct. Mem. 243 (1951). *See also* *Estate of William F. Hofford*, 4 T.C. 790 (1945).

62 INT. REV. CODE of 1954, § 2036(a)(2).

63 *Estate of Allen D. Gutchess*, 46 T.C. 554 (1966); Ehrlich, *Current Developments Involving Non-Voting Stock in Estate Planning*, N.Y.U. 26TH INST. ON FED. TAX 1275, 1282 (1968).

64 *Id.* at n. 20 (emphasis supplied).

65 *Estate of W.B. Roddenbery, Sr.*, 49 P.-H. Tax Ct. Mem. 212 (1949).

the stock. This brings it under 2036(a)(2) as a right to designate who shall possess or enjoy the property.⁶⁶

Retention by the donor of all voting stock in the corporation with the consequent ability to pay or withhold the payment of dividends has been urged by the Service as a retention of sufficient control over "possession and enjoyment" to render the gifted stock taxable. This argument was rejected in *Yeazel*. In that case the donor transferred stock to a trust which together with stock retained by her aggregated enough to control the issuing corporation. Trust income was to be paid to four beneficiaries, members of her family, and the donor was the trustee with powers to retain and vote the stock. The court stated "[a]lthough Mrs. Coyle could have prevented the corporation from paying a dividend, that action would not have deprived the beneficiaries of the possession or enjoyment of either the property or income because the retained earnings of the company would increase. . . ."⁶⁷ The court further stated that the beneficiaries were in a position to receive the economic benefit of the stock by using it as security to borrow against it and that they would have the full value when they ultimately received the stock.

A comparable situation arose later in the Tax Court in *Estate of Harry H. Beckwith*.⁶⁸ In that case the decedent created trusts for the benefit of his family which were funded with stock in his closely held corporation. Periodic payment of trust income was explicitly provided for, but the decedent retained the right to remove any trustee and appoint another. At his death the decedent had the practical ability to vote seventy-four percent of the corporate stock including proxies given him by the thirty-nine percent of that stock in the family trusts. (The corporation consistently paid cash dividends.) The commissioner argued that this ability in the decedent to control the corporation required inclusion of the stock previously given to the family trust in his estate for federal estate tax purposes. The Tax Court concluded that there was no prearranged plan giving the decedent the right to vote the stock and that without this right his ability to change trustees did not amount to a sufficient retention of powers to create taxability. The *Beckwith* case is significant beyond its holding since it reflects the position taken by the commissioner that a clear retention of voting control renders donated stock taxable.

The arguments adopted by the court in the *Yeazel* case are the same arguments urged to justify application of the gift tax annual exclusion to gifts of minority stock having no dividend history. The suggestion that such gifts may not be susceptible to the annual exclusion was adopted in the recent Tax Court case of *Leonard Rosen*.⁶⁹ Rosen and his brother were in substantial control of a family corporation. They each placed stock in the corporation in trust for their children with the income to be paid until certain ages and the corpus then

66 *Estate of James Gilbert*, 14 T.C. 349 (1950).

67 68-1 U.S.T.C. ¶ 12, 524, at 87, 387 (N.D. Ill. E.D. 1968); cf. *Chotin v. U.S.*, 68-1 USTC 12, 522 (CT. CLS.) in which transfers of minority stock within 3 yrs. of death were ruled to be in contemplation of death for the reason that no dividends were paid on the stock, the donee therefore received no enjoyment, and the donor must therefore have had predominant testamentary motivation.

68 55 T.C. 242 (1970).

69 48 T.C. 834 (1967), *rev'd Rosen v. Comm'r.*, 397 F.2d 245 (4th Cir. 1968).

delivered. The Fourth Circuit reversed a Tax Court determination that there should be no annual exclusion allowed as to the income interests. It was conceded by all parties that the future interest portion of the gift represented by the future delivery of corpus to the beneficiaries should not be entitled to an annual exclusion. The Fourth Circuit held, however, that actuarial tables should be applied to make a valuation of the income interests over the period prior to delivery of the corpus even though the stock had no history of dividend payment. (The court here made reference also to a power in the trustees to sell the stock and reinvest the proceeds.) The gift tax problems relating to the annual exclusion are discussed in more detail below. The Tax Court holding that the annual exclusion should be denied because the corporation had no dividend history to make possible valuation of the income interest given is merely another way of stating that no real value passes to the donees and would indicate that the line of thinking urged by the Service in *Yeazel* is not yet dead. It should be considered in planning whether the reasoning of the *Yeazel* case would still prevent taxation in a situation in which the corporate net income is largely siphoned off in salary, where for other reasons there is no accumulation of retained earnings, or where the controlling stockholder can prevent the same.

Revenue Ruling 67-54 sets forth the position of the Revenue Service with reference to situations where the donor retains complete voting control and control over the disposition of the donated stock (whether as trustee or alone) that he has made a transfer with retained right to designate the persons who shall possess or enjoy the transferred property.⁷⁰ The position adopted in this ruling was urged upon the court in the *Yeazel* case but rejected for the reason that there was no express retention of control over the disposition of the donated stock by the donor. The position of this ruling was again urged by the Service in *Byrum*. In this case the donor transferred a block of common voting stock in trust for his children. The donor retained the power to vote the stock and the power to veto the sale of it by the trustee. The court stated that the term enjoyment is not a word of art but is synonymous with present substantial economic benefit and found there to be no such benefit reserved by the donor. The court further found the transfer not to be taxable as a retention of the right to designate the person to possess or enjoy the property since the possible beneficiaries were limited to the children of the donor. This resembles the reasoning applicable to a marital deduction special power of appointment.

The United States Supreme Court affirmed the Circuit Court in *Byrum*

70 Rev. Rul. 67-54, 1967-1 CUM. BULL. 269,

"Where a decedent transfers nonvoting stock in trust and holds for the remainder of his life voting stock giving him control over the dividend policy of the corporation, he has retained, for a period of which did not in fact end before his death, the right to determine the income from the nonvoting stock. If he also retains control over the disposition of the nonvoting stock, whether as trustee, by restriction upon the trustee, or alone or in conjunction with another, he has in fact made a transfer whereby he has retained for his life the right to designate the persons who shall possess or enjoy the transferred property or the income therefrom. Since under section 20.2036-1 (b) (3) of the Estate Tax Regulations it is immaterial in what capacity a power was exercisable by the decedent, it is sufficient that the power was exercisable in the capacity of controlling stockholder. Under the facts of this case, therefore, the decedent has made a transfer with a reserved power within the meaning of section 2036 (a) of the Code." (emphasis supplied)

with a six to three decision, thus opening a way for tax planning based upon comparable types of voting control retention.

The following aspects of the Supreme Court's decision are particularly important from a planning point of view:

(a) The reservation of powers of management does not alone constitute a reservation of possession and enjoyment under section 2036. The Supreme Court reaffirms that "enjoyment" requires substantial present economic benefit and relies upon *Reinecke v. Northern Trust Company*⁷¹ to establish that reserved powers of trust management do not amount to control over the economic benefits or enjoyment of the property.^{71.1}

(b) The Supreme Court killed any lingering doubt as to whether retention of the right to vote transferred shares requires inclusion within the gross estate. In doing so, the court distinguished *Estate of Holland v. Commissioner*^{71.2} as involving a withholding of income until the decedent's death, as well as other rights, and referred to *Yeasel* as supporting this viewpoint. The opinion remarks that the government in its argument conceded that mere retention of the right to vote shares does not constitute "enjoyment," under section 2036 (a) 1,^{71.3} and the court stated: "Even if *Byrum* had transferred a majority of the stock, but had retained voting control, he would not have retained substantial present economic benefits."

(c) The opinion of the Supreme Court clearly recognizes the differentiation between holding property through the medium of stock in a closely held, non-public corporation and other types of property (such as publicly held stock) having a ready market. The opinion points out that such close corporations do not have regular and dependable earnings flow and states "the typical closely held corporation is small, has a checkered earning record, and has no market for its shares"^{71.4} the Court stresses that it would be unfair to allow shareholders of publicly held corporations to place such stock in an irrevocable trust, and not allow stockholders of closely held corporations to follow the same course merely because a retention of management might result.^{71.5}

(d) In stressing that the settlor of the trust did not have a retention of income control the court makes reference to both a trustee's duties to the beneficiaries and a controlling shareholder's duties to his minority stockholders. The opinion indicates that while a controlling stockholder having power to abuse his holdings to his own benefit and to the detriment of minority shareholders might do so, he is nevertheless a fiduciary obligated to act as such. The Supreme Court's analysis is that taxability is to be determined on the basis of the legal obligations to the minority shareholders not on the basis of what possibilities for abuse of power are open to the donor, after the gift.

(e) The majority opinion in *Byrum* also disposes of the argument that voting control makes it possible to curtail dividends and thereby accumulate

71 278 U.S. 339 (1929).

71.1 408 U.S. 125, 146 (1973); *reh. den.* 409 U.S. 898 (1973).

71.2 *Estate of Pamela D. Holland*, 47 B.T.A. 807 (1942), *modified*, 1 T.C. 564 (1943).

71.3 INT. REV. CODE OF 1954, § 2036(a)(1).

71.4 408 U.S. 125, 149 (1973).

71.5 *Id.* at 149 n.34.

income which augments the value of the donor's retained stock. This power does not change the economic picture, since the benefit is equally apportioned to the owners of stock regardless of the control element. The *Byrum* case still does not quite reach the fact situation treated of in Ruling 67-54. The ruling relates to the type of corporation having a capital structure consisting of non-voting preferred (presumably to the extent of the corporate asset value) retained by the donor, a small class of voting common, and a much larger class of non-voting common which constitutes the subject matter of the gift.

In the absence of a restriction on resale of the stock by the donee, the donor's retention of voting control, even if absolute, does not appear under the above cases to be sufficient to cause inclusion of the donated stock in his estate.⁷² However, the extent to which restrictive agreements may be coupled with retention of voting control remains undetermined and should be approached with care. It has been suggested that Section 2038 could be relied upon by the Service to attack transfers of stock upon the pattern discussed in Ruling 67-54.⁷³ It could be urged that retention of controlling stock in the immediate family of the donor following the gift constitutes substantial control and that there should at least be no reduction in value for lack of control of the stock remaining in the hands of the donor-decedent. It is of interest to note that the Tax Court in the *Estate of David J. Levenson*⁷⁴ made specific reference to the total family group control of stock in valuing the shares in the hands of the deceased. The corporation involved had 2,400 issued shares (unlisted). The decedent owned 155 shares, his wife and their sons owned 1,475 shares, the wife's relatives owned 406 shares and a nonrelated stockholder 364. The Service urged adoption of the book value of the company stock. The court found the value at 92.98% of the book value and made reference to the factor of strong family control.

Augmentation of value for stock constituting corporate control has been suggested by the Internal Revenue Service. Ruling 59-60 reflects the position of the Service in asserting that although it is true that a minority interest in an unlisted corporation stock is more difficult to sell than a similar block of listed stock, it is equally certain that control of a corporation, *either actual or in effect*, representing as it does an additional element of value may justify a higher value for a particular block of stock.⁷⁵ In Revenue Ruling 67-54, with reference to the effect of degree of control on the value of unlisted stock, it is stated:

Where the block consists of the voting common stock of a corporation, a substantial portion of the entire value of the common stock is to be attributed to that block, and hence the per share value of the voting stock should be relatively larger than the per share value of the nonvoting stock. . . . Under Section 2031 of the Code, the value of the nonvoting shares included in the gross estate should reflect the additional value inherent in the closely held voting shares by reason of control of the company policies.⁷⁶

The Internal Revenue Service has advanced this argument to the courts on oc-

72 A.B.A., BULLETIN OF THE SECTION OF TAXATION 444 (Winter, 1968).

73 Ehrlich, *supra* note 63, at 1278.

74 18 TCM 535, *modified*, *Levenson's Estate v. Comm'r*, 282 F.2d 581 (3rd Cir. 1960).

75 Rev. Rul. 59-60, 1959-1 CUM. BULL. 243.

76 Rev. Rul. 67-54, 1967-1 CUM. BULL. 270.

casion with some success. The highest court passing on this question, the Court of Appeals for the Fifth Circuit, has agreed with the Service to a degree in the case of *United States v. Parker*.⁷⁷ In that case it was held that shares of a corporation amounting to eighty percent of its outstanding stock should be valued in excess of 80% of the corporate asset value, and that family stock should be aggregated under Section 1239(a). In the *Estate of Robert Hosken Damon*,⁷⁸ the deceased owned 240,801 shares of the common stock of a corporation having 721,765 shares outstanding. The Service argued to the court that the stock had a higher value than the market because the block owned by the estate represented effective control of the corporation. The court did not meet this argument in its opinion, but found that the stock did not represent either actual or effective control and did not take this factor into account in valuing.

The following further considerations might be suggested with reference to the valuation of retained stock, with retained control. Total retention of voting control would not increase the market value of the shares if this retention is personal to the donor only. (Retention to the donor, personally, may be a problem under Section 2036, but is of no interest to a prospective purchaser of the stock, since he will receive only the voting control inherent in the stock ownership itself.) The same considerations would apply to restrictions on stock transfer of the gifted stock if such restrictions are personal to the donor such as the trust restrictions in the *Byrum* and *Yeazel* cases, as opposed to restrictions running with the stock. It may, however, be helpful to the potential purchaser that restrictions running with the stock will keep the number of other stockholders restricted. Even though the donor may reserve to himself the power to vote the donated shares, the donees still have all the rights and remedies of minority stockholders if their position is abused such as through the payment of excessive salaries to himself by the donor. The reservation of voting control in the donor allows the perpetuation of himself as the controlling officer of the corporation, which may be of value to a prospective purchaser, and allows him to pay or withhold dividends. This last element would not influence a prospective purchaser very much since it does not affect either the dividends which he will receive or the retained earnings attributable to his shares.

VII. Caveats to Estate Planning Through Incorporation

Use of incorporation as a form for the holding and disposition of assets for estate planning purposes has its costs and hazards like any other tax avoidance or property succession arrangement. Estate tax avoidance through deliberate reduction in stock values is paid for by the owner of the assets involved in terms of reduction in operating control, loss of income, and loss of ability to liquidate the assets placed in the corporate form. In concluding whether or not incorporation is an appropriate part of the estate plan, the following factors should be taken into account.

A. The unincorporated owner, by giving undivided fractional interests to his

⁷⁷ 376 Fed. 2d 402 (5th Cir. 1967).

⁷⁸ 49 T.C. 108 (1967).

children, will produce assets to be discounted in his estate even if the gift is made in the three-year period. Discounts for undivided ownerships in the neighborhood of fifteen percent are allowed regularly by the courts.⁷⁹ To the extent the assets involved lend themselves to the giving of fractional interests, the advantages of the use of the corporate form are lessened.

B. The incorporated owner suffers the disadvantage after his gifts reach one-third of the outstanding stock of having no control over liquidation of his operation, ability to sell it, or even ability to borrow against it without the consent of his minority stockholders.

C. The incorporated owner is subject to all the hazards of outstanding minority stock particularly in the event of any falling out among the family. Minority stockholders have various rights for the protection of their stock value such as inspection of the corporate books, dividends to the extent of available income, etc., which can be of great harassment to the majority stockholder.

D. The incorporated owner is subject to the costs of operating in corporate form and the nuisance of annual reports to the state.

E. The incorporated owner, who makes any substantial amount of gifts, is in effect locked into the corporation so long as he lives and loses the flexibility of control over his operation and its assets which the unincorporated owner making his gifts in kind retains.

F. Effect of the above factors can be reduced through voting right retention by the donor to the extent that retention of voting control by him can take place without frustrating his objectives and to the extent permitted by the estate tax cases discussed above.

VIII. Corporate Stock Gifts and the Gift Tax Annual Exclusion

In planning any gift program involving minority shares in a family corporation the availability of the \$3,000.00 annual exclusion per donee can be of crucial importance.⁸⁰ The present gift tax cost of a particular program as opposed to the estate tax avoided in the future is a central factor in the decision of whether to pursue a particular gift program and of what form gifts are to be made in. The methods of giving such stock are generally:

1. Outright gift of ownership from the donor to the donee;
2. Gift of ownership subject to various restrictive agreements limiting the right of the donee to resell the stock or providing for repurchase upon certain contingencies, by other stockholders or the corporation; and
3. Gift of the stock into a trust with the income assigned to certain donee

⁷⁹ A discount of fifteen percent from the pro rata share of market value was allowed in the valuation of an undivided one-third interest in real estate in *William R. Stewart, Jr., Et Al., Executors*, 31 B.T.A. 201 (1934). Upon proof showing that market discounting of undivided fractional interests in real estate was common practice in the community, a discount of twelve and one-half percent was allowed in *Estate of Nina M. Campanari*, 5 T.C. 488 (1945).

⁸⁰ INT. REV. CODE of 1954 § 2503 (1972).

or donees and the remainder following the life or lives of the income beneficiaries, then to others (other forms of future interest ownership of stock, such as life estate and remainder, would be treated for gift tax purposes the same as the trust situation).

Peculiar problems in this context arise with close corporation stock as contrasted with stock in a publicly held corporation. Publicly held stock having a regular dividend history and an established market readily lends itself to the calculation of value transmitted to income beneficiaries, and its value is readily capable of ascertainment. Close corporation stock, on the other hand, normally has no regular dividend history, and normally has no established value in the market place.

Gift tax exclusions for gifts of close corporation stock have been attacked by the Revenue Service, in some situations, on the grounds that income interests, as such, are incapable of valuation without a dividend history; close corporation stock given outright is not sufficiently susceptible of definite valuation as to allow the annual exclusion; and in certain circumstances such gifts may be future interests not susceptible to the exclusion. In the *Rosen* case, previously discussed, the Revenue Service argued that the lack of dividend history in the corporate stock placed in trust by the taxpayer made valuation of the interest given to the income beneficiaries impossible and that they should therefore be denied the annual exclusion.⁸¹ The Circuit Court, instead, held that the principal value of the stock should be determined and the income interest of the income beneficiaries actuarially calculated from that regardless of the dividend history. The court stressed that the trustees had the power to sell the stock and reinvest the proceeds in other forms of investment.

It has been noted that occasionally examining agents will even take the position that the annual exclusion should not be allowed on outright gifts where there is no dividend history for the reason that the value to the donee is not capable of being determined. In consideration of this subject, the case of *Heringer v. Commissioner*⁸² should be carefully considered. The *Heringer* case involved, in essence, the creation of a corporation by two brothers with issuance of stock forty percent to the brothers and sixty percent to their children. The initial contribution of capital was cash. The following year the brothers transferred farmlands to the corporation, which leased the land back to a partnership comprised of certain of the children of the brothers. The Circuit Court stated that they would not decide the point of whether the gifts were, in substance, to the donors' children or to the corporation for purposes of determining the number of annual exclusions allowable for the reason that even though the children be deemed donees, the interests taken by them would be "future interests."

The Circuit Court based this conclusion on the case of *Ryerson v. United States*,⁸³ which involved a gift to a trust having two beneficiaries who were also

81 48 T.C. 834 (1967), *rev'd* *Rosen v. Comm'r*, 397 F.2d 245 (4th Cir. 1968), cf. *Stark v. U.S.* (W.D. Mo. 1972). Gifts of close corporation stock paying no dividends should not be allowed annual exclusion to the life beneficiaries of a trust of the stock, by reason of lack of susceptibility to valuation.

82 235 F.2d 149 (9th Cir. 1956).

83 312 U.S. 405 (1941).

trustees; by the terms of the trust, both had to agree to any distribution of income or corpus. The Circuit Court reasoned, since the declaration of dividends from the corporation required the joint action of the stockholders, which action no single stockholder could perform, the gift was necessarily a future interest as to each individual donee-stockholder.

This reasoning would appear to be, in its nature, an application of the approach taken by the United States Supreme Court in the case of *Fondren v. Commissioner*.⁸⁴ The key language is: "Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest."⁸⁵ This principle fully applied in the trust situation from which it arose results in the separate handling of income and principal, reflected in the Gift Tax Regulations. They hold that an "unrestricted right to the immediate use, possession or enjoyment of property or the income from property is a present interest in property."⁸⁶ As stated in *LaFortune v. Commissioner*:

Separate and independent consideration must be given to the gift of the corpus and to the gift of the income. If the income of a trust is required to be distributed periodically, as annually, but distribution of the corpus is deferred, the gift of the income is one of a present interest and the gift of the corpus is one of a future interest.⁸⁷

The appropriate analysis of the applicability of the annual exclusion to such gifts follows.

The trust situation, if it does not involve a required periodic distribution of income, is inevitably a situation of potentially postponed enjoyment. If the beneficiary may not upon his own decision require present income benefit or present payment of corpus, he necessarily has nothing of present economic value; *i.e.*, he does not have a *marketable* ownership. It seems inevitable that the annual exclusion should be denied in such a situation since the beneficiary's interest in the gift is incapable of market valuation and incapable of being sold or reduced to cash by the beneficiary as to the income right. A deferral of right to corpus is within the common law definition of "future interest" and disallowance of annual exclusion as to it is within the literal meaning of Section 2503(b).⁸⁸

A gift of property to a corporation, as in the *Heringer* situation, is in some respects analogous to a gift of property into a preexisting trust, and the reasoning of the Ninth Circuit is, apparently, that the stockholder's position is like that of a beneficiary who cannot reach the actual subject of the transfer.

The gift of a share of corporate stock itself, as the subject of the gift, is economically, logically, and legally a different matter. A share of corporate stock is a discrete item of property in itself having a cash market value. The apprehended difficulty of securing dividend income on such a share is merely one of the factors affecting its market value. It certainly does not render the stock in-

84 324 U.S. 18 (1945).

85 *Id.* at 20-21.

86 INT. REV. CODE OF 1954, § 2503-1'(b).

87 263 F.2d 186 (10th Cir. 1958).

88 INT. REV. CODE OF 1954, § 2503(b).

capable of valuation or disabled from marketability, as the beneficiary's interest in trust corpus may well be. The logical separation of income and corpus, utilized in approaching problems of trust law, is completely inapplicable to a treatment of corporate shares as such since every legal right attaching to the corporate share, after a direct gift of it without reservation, is wholly in the hands of the donee.

It is apparent from the above-cited authorities that the problem of annual exclusion for a given gift is necessarily interwoven with the susceptibility of that gift to valuation. Where the species of property right involved is not one necessarily, by its own terms, having enjoyment postponed into the future (such as a remainder interest after a life estate) the "barrier to enjoyment" test of the *Fondren* case may be, with the same results, cast in terms of whether the particular property right involved is susceptible of market valuation or whether it contains such contingencies as to be incapable of such. Necessarily, a property right which has a barrier between the desire of the beneficiary and his capability of enjoying it will be of much less value than a "present interest." It is interesting that the court in the *Heringer* case goes to great lengths to avoid committing itself on the question of what the valuation of the property right received by the ultimate donees would be. The court delicately phrases its opinion to state that the Gift Tax would not apply to the forty percent interest retained by the donors but does not commit itself otherwise.

In summary, it would appear that the right of a donee-stockholder to exercise every possible aspect of control over the stock share or shares received by him, his present ability to reduce the same to cash in the market place, and the lack of any barrier existing between the stockholder's desire to realize the benefit of his stock and his ability to do so renders the stock a present interest, eligible for annual exclusion. The stockholder in such a situation is well within the classic language of *Curry v. McCanless*, which states that a present power of disposition for one's own benefit is the equivalent of ownership.⁸⁹ In utilizing any trust or future interest arrangement, the *Rosen* case should be carefully examined to assure that the maximum annual exclusions are obtained. Before contributing additional property to a corporation from which stock has been given, the problems created by the *Heringer* case should be carefully considered. It would appear that such a contribution of capital does constitute a gift if no stock is received by the donor in exchange for it and that such a gift would have no annual exclusion available to it. In this situation, therefore, the donor should first contribute property to the corporation in exchange for stock at its proper valuation and then make gift of the stock to such donees as he desires to have it.

IX. Audit Review of Estate Tax Returns Involving Close Corporation Stock

It is typical of Revenue Service practice at the examining agent level to allow no discounts as such in the valuation of corporate stock in a close corporation. With the examining agent, audit is typically approached by negotiation of the values of the underlying assets until either a result satisfactory to the taxpayer from that approach is obtained or the audit is closed on an unagreed basis.

⁸⁹ 307 U.S. 357, 371 (1939).

Typically at the Conference Staff level, negotiation can proceed with regard to application of valuation factors to individual stockholdings related to their percentage of outstanding stock and the effect of this on marketability of the holding. The factor that is difficult for both the Revenue Service and the taxpayer to clearly incorporate in audit settlement discussions is that of the realistic market possibility for minority stockholdings in such corporations. For example, the holding of the taxpayer in the *Katz* case⁹⁰ of one-fifth of the outstanding stock of the corporation involved was essentially unmarketable; and the Tax Court concluded to discount it to fifty percent of its proportionate value of the underlying assets for that reason. In such situations there is usually a family group identity involved among the stockholders of the corporation and an implicit feeling, at least on the part of the estate tax examiner, that the minority stockholder is largely under the control of the donor-testator from whom his stockholding originated. For this reason, examiners and conferees are reluctant to allow valuations really reflective of what the minority stockholding could actually be sold for. Representatives of the taxpayer are, on the other hand, often reluctant to pursue the valuation situation too far in view of the possibility of coming up against arguments that collusive situations rendering the gift taxable under § 2036 as one with possession and enjoyment retained might be encountered.

The Revenue Service has established no coherent position in approaching these situations. It is conceivable that attempts might be made to extend the concept of controlled stock (stock owned by a taxpayer's family group) to the estate tax area.⁹¹ It is possible that attempts may be made to tax the decedent on all family group stock deriving from gifts by the decedent as if it formed a part of his holdings at the date of his death. To date no such position has been taken by the Revenue Service. This possibility should be at least considered, however, in the course of estate planning; and certainly every attempt should be made to eliminate even the appearance of collusive arrangements for the control of gifted stock by the donor, other than explicit arrangements to the extent approved by the courts.

Conclusion

The close corporation, like the trust, provides a method for separating the management of property from the ownership of property. It is this separation of management and ownership which is the essential element of the utility of trusts in both asset management and tax planning. The majority opinion of Mr. Justice Powell in *Byrum* recognizes that the same separation of management and ownership ("substantial present economic benefit") may obtain in the corporate form.⁹² The corporation is generally more appropriate than the trust in administering and allocating the benefit of *business assets*, as opposed to assets of a more static investment nature, and should take its place as an appropriate estate planning medium when business assets are involved.

90 68 P.-H. Tax Ct. Mem. at 190.

91 Estate of David J. Levenson, 18 T.C.M. 535, *modified*, 282 F.2d 581 (3d Cir. 1960) provides an example of an application of the "family group" concept in another context.

92 408 U.S. 125, 149 (1973), *reh. den.* 409 U.S. 898 (1973).